KETUA PENGARAH HASIL DALAM NEGERI v. WATSONS PERSONAL CARE STORES (M) HOLDINGS LTD

HIGH COURT MALAYA, KUALA LUMPUR
AHMAD KAMAL MD SHAHID J
[CIVIL APPEAL NO: WA-14-20-06-2020]
17 APRIL 2023

Abstract – *While the Director General of Inland Revenue ('DGIR') has the power to disregard structures that differ from those which would have been adopted by independent persons behaving in a commercially rational manner, and the actual structure impedes the DGIR from determining on appropriate transfer price, if the DGIR so chooses to disregard the structure under r. 8(1) of the Income Tax (Transfer Pricing) Rules 2012, r. 8(2) requires the DGIR to make the adjustment as it thinks fit to reflect the structure that would have been adopted by the independent person dealing at arm's length.*

REVENUE LAW: *Income tax – Appeal – Appeal by Director General of Inland Revenue ('DGIR') against deciding order of Special Commissioners of Income Tax ('SCIT') – SCIT allowed company's appeal and set aside notices of assessment and additional assessment issued by DGIR pursuant to adjustment made under s. 140A of Income Tax Act 1967 – Whether s. 140A allowed DGIR to completely disallow interest payments without justification – Whether s. 140A allowed DGIR to disregard interest payment without providing more 'suitable' arm's length rate – Whether DGIR acted reasonably and within powers statutorily provided – Whether assessment raised by DGIR in accordance with s. 140A – Whether penalty imposed correct*

This was an appeal by the appellant, the Director General of Inland Revenue ('DGIR'), against the deciding order of the Special Commissioners of Income Tax ('SCIT') allowing the respondent's ('company') appeal and setting aside the notice of additional assessment for the year of assessment ('YA') 2010 and notices of assessment for YAs 2011 and 2012 ('impugned assessments') which had been issued by the DGIR, pursuant to the adjustment made under s. 140A of the Income Tax Act 1967 ('ITA'). In 2003, the company borrowed USD36,842,335 from Watsons Labuan in order to acquire a substantial number of shares in Watsons Malaysia. In 2012, the company borrowed another USD1,276,000 from Watsons Labuan to finance the acquisition of shares. The amount of money borrowed from Watsons Labuan was to be paid interest by the company at the rate of 3% plus the London Interbank Offered Rate ('LIBOR') on a yearly basis and the principal amount borrowed was to be paid on demand by Watsons Labuan. The DGIR

requested information from the company relating to cross-border transactions for transfer pricing risk assessment purposes by completing Form MNE for YAs 2010 and 2011. The DGIR informed the company that (i) the interest paid by the company for money borrowed in YAs 2010 to 2012 would be adjusted under s. 140A of the ITA and rr. 8(1)(b) and 8(2) of the Income Tax (Transfer Pricing) Rules 2012 ('TP Rules'); and (ii) the interest paid by the company for money borrowed was not allowed as a deduction because the money borrowed was not at arm's length transactions. The DGIR gave reasons for the issuance of the additional assessments and the imposition of s. 140A of the ITA which were: (i) the transaction was with an associated enterprise; (ii) the non-repayment of the principal sum was contrary to art. 9 of the Model Tax Convention on Income and on Capital; (iii) the transaction was not based on terms that would have been agreed between independent parties; and (iv) the whole transaction was ignored by the DGIR under s. 140A of the ITA. Therefore, the company filed notices of appeal against the DGIR's decision. The SCIT allowed the company's appeal. The DGIR then filed a notice of appeal against the SCIT's decision, thereby resulting in the present appeal. The following issues had been appealed by the company before the SCIT, which were now required for determination before this court being an appeal by the DGIR, (i) whether s. 140A of the ITA allowed the DGIR to completely disallow the interest payments without justification; (ii) whether s. 140A of the ITA allowed the DGIR to disregard the interest payment without providing a more 'suitable' arm's length rate; and (iii) whether the DGIR acted reasonably and within its powers provided for under s. 140A of the ITA to substitute the interest rate, which the company had proved to be at arm's length rate, with 0%. The DGIR's issues were (i) whether the assessment raised by the DGIR for the YAs 2010, 2011 and 2012 were in accordance with s. 140A of the ITA; and (ii) whether the penalty imposed under s. 113(2) of the ITA was correct. The central issue under appeal was whether the adjustment by the DGIR made to the interest expense on the loan that was obtained by the company from its related company was in accordance with s. 140A of the ITA and the TP Rules.

Held (dismissing appeal):

(1) Having regard to rr. 8(1) and 8(2) of the TP Rules together, it was clear that while the DGIR has the power to disregard structures that differ from those which would have been adopted by independent persons behaving in a commercially rational manner and the actual structure impedes the DGIR from determining on appropriate transfer price, if the DGIR so chooses to disregard the structure under r. 8(1), r. 8(2) requires the DGIR to make the adjustment as it thinks fit to reflect the structure that would have been adopted by the independent person dealing at arm's length. (para 20)

(2) The company had prepared the transfer pricing documentation in respect of the loan ('TO documentation'), explaining how it arrived at the arm's length interest rate of LIBOR +3% and provided the same to the DGIR for its review. Once the TP documentation was presented, the DGIR must provide its basis, supported by facts and law, for rejecting the said TP documentation. Unfortunately, the DGIR failed to provide any documentation to rebut the evidence submitted by the company. The SCIT was, in fact, unable to seriously consider any of the DGIR's analysis as the DGIR did not proffer any evidence that they performed any serious transfer pricing analysis report. No function, asset and risk analysis were undertaken by the DGIR that could be proved by way of documentary evidence submitted to the SCIT. If the DGIR disagreed with the TP documentation, the DGIR would have commissioned a counter-veiling TP study. This was not done by the DGIR. The company's TP documentation was demonstrated to comply with the TP Guidelines 2012 and, in the absence of a contrary transfer pricing report prepared by the DGIR, the company's version must be accepted and the impugned assessments were erroneous and excessive. The SCIT had correctly found that there was no evidence from the DGIR to show that the company's TP documentation was unreliable and, in the absence of such evidence, the company had proved its case that the interest rate was at arm's length. (paras 22-32)

(3) It was perplexing that the DGIR claimed that insufficient comparison was made between transactions per r. 6 of the TP Rules. In contrast, the DGIR had not put forward any evidence to refute the company's TP analysis and there was no basis on which the DGIR would have concluded that the interest charged was higher than what would have been agreed between independent persons. Therefore, the DGIR's rejection of the comparables amounted to a bare denial, lacking in evidence or basis as the SCIT had correctly held. In the circumstances, the DGIR did not substantiate its allegations in any documentary form to show that the interest rate was not at arm's length. The SCIT's decision was founded on a correct application of the law and inference of facts that were consistent with the primary facts and evidence of the case. (paras 35-38)

(4) The DGIR was utilising s. 140A of the ITA to disregard the transactions undertaken. Thus, the DGIR did not act within the powers conferred to it under the said section. Section 140A of the ITA does not give the DGIR the power to disregard/ignore any transactions. Instead, s. 140A clearly requires the DGIR to substitute the price in respect of the transaction to reflect an arm's length price for the transaction where it has reasons to believe that the transactions were not carried out at arm's length. Therefore, the SCIT had correctly held that the DGIR's failure to make any adjustments to the loans or substitute an arm's length rate was contrary to s. 140A of the ITA. (paras 39-41)

(5) The position taken by the DGIR was based solely on its reference to Investopedia. No other findings or TP report or any form of analysis was shown to the company nor the SCIT. Investopedia was not an authority on the issues alleged by the DGIR. The writings contained on the website were not authoritative and should not be used as a tool to determine TP analysis under s. 140A of the ITA. This showed that the justification and the reasoning on the part of the DGIR to impose s. 140A of the ITA on the company was flawed. The DGIR's basis for invoking s. 140A of the ITA amounted to an error of law. The position adopted by the DGIR was not justifiable. Failure to provide a TP report and to support this with sufficient evidence clearly showed that the DGIR did not act lawfully and wrongly. Thus, the company's TP documentation should be maintained and all adjustments made by the DGIR with regards to transfer pricing against the company should be disregarded. (paras 46-50)

(6) The SCIT's deciding order was founded on a correct proposition of the law and inference of facts and arrived at based on correct conclusions drawn from the facts agreed and proved in that: (i) the SCIT correctly appreciated the evidence or the facts and made finding of facts which a reasonable person in the circumstances would have arrived at; (ii) the SCIT arrived at finding of facts which were wholly supported by facts or evidence; (iii) there were no material inconsistencies or inaccuracies in the SCIT's deciding order; and (iv) the SCIT took into account relevant factors and disregarded irrelevant factors in arriving at its decision. The SCIT's findings were rational and cogent and there were no flaws in its reasoning or the conclusions. It could not be said that the findings of the SCIT were irrational or perverse. (paras 52 & 53)

(7) The company had obtained professional advice from a reputable firm in determining its tax liability in relation to the issues at hand. This indicated that the company did not deliberately or recklessly submit an incorrect return. The fact that the company had acted in good faith, took professional advice and made full disclosure to the DGIR constituted sufficient grounds to set aside the penalties imposed. (paras 60-62)

Case(s) referred to:

Aik Ming (M) Sdn Bhd & Ors v. Chang Ching Chuen & Ors & Another Case [1995] 3 CLJ 639 CA ***(refd)***

Development Sdn Bhd v. Ketua Pengarah Hasil Dalam Negeri [2011] 13 MLRH 493 ***(refd)***

Director-General Of Inland Revenue v. Khoo Ewe Aik Realty Sdn Bhd [1990] 2 CLJ 160; [1990] 1 CLJ (Rep) 91 SC ***(refd)***

I Investment Ltd v. Comptroller-General of Inland Revenue [1975] 1 LNS 61 FC ***(refd)***

Kenny Heights Development Sdn Bhd v. Ketua Pengarah Hasil Dalam Negeri [2015] 5 CLJ 923 CA ***(refd)***

Ketua Pengarah Hasil Dalam Negeri v. Firgos (M) Sdn Bhd [2014] 8 CLJ 943 HC ***(refd)***

Ketua Pengarah Hasil Dalam Negeri v. Kim Thye & Co [1992] 4 CLJ 2079; [1992] 1 CLJ (Rep) 135 SC ***(refd)***

Ketua Pengarah Hasil Dalam Negeri v. Procter & Gamble (Malaysia) Sdn Bhd [2022] 1 LNS 754 HC ***(refd)***

Lower Perak Co-Operative Housing Society Bhd v. Ketua Pengarah Hasil Dalam Negeri [1994] 3 CLJ 541 SC ***(refd)***

MM Sdn Bhd v. Ketua Pengarah Hasil Dalam Negeri [2013] MSTC 10-046 ***(refd)***

Office Park Development Sdn Bhd v. Ketua Pengarah Hasil Dalam Negeri [2011] 13 MLRH 493 ***(refd)***

Legislation referred to:

Income Tax (Transfer Pricing) Rules 2012, rr. 6, 8(1), (2)

Income Tax Act 1967, ss. 113(2), 140A(1), (3)

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Reported by Najib Tamby

JUDGMENT

Ahmad Kamal Md Shahid J:

Introduction

[1] This is an appeal (encl. 1) by Ketua Pengarah Hasil Dalam Negeri, the appellant (DGIR) against the deciding order of the learned Special Commissioners of Income Tax (SCIT) dated 15 May 2020 which allowed the respondent's (company's) appeal and set aside the notice of additional assessment for the year of assessment (YA) 2010 and notices of assessment for YA 2011 and 2012 all dated 29 December 2014 respectively (collectively, impugned assessment) which have been issued by the DGIR pursuant to the adjustment made under s. 140A of the Income Tax Act 1967 (ITA).

[2] The particulars of tax in the notice of additional assessment for YA 2010 and notices of assessment for YA 2011 and YA 2012 all dated 29 December 2014 are as follows:

Year of Assessment (YA)	Date of Notice of Additional Assessment /Notice of Assessment	Additional/ Original Tax RM
2010	29.12.2014	1,569,089.69
2011	29.12.2014	1,372,779.38
2012	29.12.2014	1,457,335.63

[3] After the hearing, I dismissed the DGIR's appeal in encl. 1. The grounds for my decision appear below.

A

Background Facts

[4] The facts of the case can be found in the grounds of the decision of the SCIT and reproduced below with suitable modifications:

(a) In 2003, the company borrowed USD 36,842,335.00 from Watson Labuan in order to acquire a substantial number of shares in Watson Malaysia;

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(b) In 2012, the company borrowed another USD 1,276,000.00 from Watson Labuan to finance the acquisition of shares;

(c) The amount of money borrowed from Watson Labuan is to be paid interest by the company at the rate of 3% plus the London Interbank Offered Rate (LIBOR) on a yearly basis and the principal amount borrowed is to be paid on demand by Watson Labuan;

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(d) In 29.7.2013, the DGIR requested information from the company relating to cross border transactions for transfer pricing risk assessment purposes by completing Form MNE for YA 2010 and 2011;

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(e) On 10.11.2014 the DGIR informed the company that:

(i) The interest paid by the company for money borrowed in YA 2010 to 2012 will be adjusted under section 140A of the ITA and Rules 8(1)(b) and 8(2) of the Income Tax (Transfer Pricing) Rules 2012 (TP Rules); and

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(ii) The interest paid by the company for money borrowed is not allowed as a deduction because the money borrowed is not at arm's length transactions.

(f) On 29 December 2014, the DGIR gave reasons for the issuance of the additional assessments and the imposition of section 140A of the ITA as follows:

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(i) The transaction is with an associated enterprise;

(ii) The non-repayment of the principal sum is contrary to Article 9 of the Model Tax Convention on Income and on Capital;

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(iii) The transaction is not based on terms that would have been agreed between independent parties; and

(iv) The whole transaction is ignored by the DGIR under section 140A of the ITA.

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(g) Therefore, the company filed notices of appeal against the DGIR's decision on 22.1.2015.

(h) On 15 May 2020, the SCIT handed its decision and allowed the company's appeal. The DGIR then filed a Notice of Appeal dated 5.6.2020 against the SCIT's decision, thereby resulting in the present appeal.

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The Law

[5] It is trite law that a decision of SCIT can be set aside if the decision is tainted with the error or misconception of law or the decision is not supported by the evidence before the SCIT.

[6] This principle of law has been succinctly explained in the case of *Lower Perak Co-Operative Housing Society Bhd v. Ketua Pengarah Hasil Dalam Negeri* [1994] 3 CLJ 541; [1994] 1 MLRA 262; [1994] 2 AMR 1735; [1994] 2 MLJ 713, in the following manner:

> First of all, it would be pertinent to say that in consideration of this appeal we have kept in the forefront of our minds the much-quoted principles enunciated by Lord Radcliffe in *Edwards v. Bairstow and Harrison*, regarding *the duty of the court when hearing appeals from commissioners in tax cases*. It will be recalled that in that case what Lord Radcliffe said (at pp 35-36) was this:
>
> > I think that the true position of the court on all these cases can be shortly stated. If a party to a hearing before commissioners expresses dissatisfaction with their determination as being erroneous in point of law, it is for them to state a case and in the body of it to set out the facts that they have found as well as their determination, I do not think that inferences drawn from other facts are incapable of being themselves findings of fact, although there is value in the distinction between primary facts and inferences drawn from them. *When the case comes before the court it is its duty to examine the determination having regard to its knowledge of the relevant law. If the case contains anything ex facie which is bad law and which bears upon the determination, it is, obviously, erroneous on point of law. But, without any such misconception appearing ex facie, it may be that the facts found are such that no person acting judicially and properly instructed as to the relevant law could have come to the determination under appeal. In those circumstances, too, the court must intervene*. It has no option but to assume that there has been some misconception of the law and that this has been responsible for the determination. So there, too, there has been error in point of law. I do think that it much matters whether this state of affairs is described as one in which there is no evidence to support the determination or as one in which the evidence is inconsistent with and contradictory of the determination, or as one in which the true and only reasonable conclusion contradicts the determination. Rightly understood, each phrase propounds the same test. For my part, I prefer the last of the three, since I think that it is rather misleading to speak of there being no evidence to support a conclusion when in cases such as those many of the facts are likely to be neutral in themselves, and only to take their color from the combination of circumstances in which they are found to occur.

In *Chua Lip Kong v. Director-General of Inland Revenue*, Lord Diplock when delivering the unanimous judgment of the Privy Council in a tax appeal had occasion to refer, with approval, to the observations of Lord Radcliffe aforesaid in the following terms:

> ... It is *plainly wrong in law; or else it is a conclusion of mixed fact and law that no reasonable special commissioners could have reached if they had correctly directed themselves in law*. Whichever way it is looked at, it falls within the well-known principles laid down by Viscount Radcliffe in *Edwards v. Bairstow*. *It is a conclusion or decision of the special commissioners which the High Court was entitled to the ought to have set aside*.

And, in *Lim Foo Yong Sdn Bhd v. Comptroller-General of Inland Revenue*, when delivering the unanimous judgment of the Privy Council, Lord Oliver indicated in what circumstances a court might interfere with the decision of the special commissioners. Here is what His Lordship said [at p 169]:

> The special commissioners are, of course, as the Federal court rightly observed, the judges of fact, but in finding the facts and drawing interferences of secondary fact from them, they *must not misdirect themselves and they must draw conclusions from facts having probative value. In their Lordships' judgment, the special commissioners in this case both misdirected themselves by reaching conclusions inconsistent with primary facts found by them and drew inferences from matters which were of no probative value in supporting their conclusions.* (emphasis added)

[7] Further guidance can be gleaned from the decision of the Federal Court in *I Investment Ltd v. Comptroller-General Of Inland Revenue* [1975] 1 LNS 61; [1975] 1 MLRA 669; [1975] 2 MLJ 208 where Raja Azlan Shah FCJ (as the late Royal Highness then was) held:

> [28] It has been said more than once that when we come to deal with income tax cases, **we must look at all the surrounding circumstances**, not for the purpose of considering what one's own conclusion might be, but for the purpose of seeing, in fact, whether there is evidence both ways – whether there is evidence upon which the Special Commissioners could arrive at their conclusion ... (emphasis added)

[8] Further, the then Supreme Court in the case of *Director-General Of Inland Revenue v. Khoo Ewe Aik Realty Sdn Bhd* [1990] 2 CLJ 160; [1990] 1 CLJ (Rep) 91; [1990] 1 MLRA 373; [1990] 2 MLJ 415 at p. 97 (CLJ); p. 419 (MLJ) held as follows:

> *It is hardly necessary for any lawyer to be reminded that under our Income Tax Act 1967 (paras 34, 39, 41 and 42 of Schedule 5 of the Income Tax Act 1967) one may only appeal to the High Court and then to the Supreme Court on a question of law. The decision of the Special Commissioners of Income Tax as to the facts is therefore, conclusive*. In this connection, it is interesting to note the following statement by Lord Denning on the powers of the High Court on appeal in *Griffiths v. JP Harrison (Watford) Ltd* at p. 916:

> Now the powers of the High Court on an appeal are very limited. *The judge cannot reverse the commissioners on their findings of fact. He can only reverse their decision if it is 'erroneous in point of law'*. Now here the primary facts were all found by the commissioners. They were stated in the case. They cannot be disputed. What is disputed is their conclusion from them. It is now settled, as well as anything can be, that their conclusion cannot be challenged unless it was unreasonable, so unreasonable that it can be dismissed as one which could not reasonably be entertained by them. *It is not sufficient that the judge would himself have come to different conclusion*. Reasonable people on the same facts may reasonably come to different conclusions; and often do. Juries do. So, do judges. And are they not all reasonable men? *But there comes a point when a judge can say that no reasonable man could reasonably come to that conclusion. Then, but not till then, he is entitled to interfere*.
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> *A court would not therefore disturb findings of fact by the Special Commissioners unless it considers that the only reasonable conclusion on the evidence contradicts the determination of the Special Commissioners* (see *Edwards v. Bairstow, Director-General of Inland Revenue v. LCW* at p 251 and *Kota Kinabalu Industries Sdn Bhd v. Director-General of Inland Revenue* at p 190). (emphasis added)

[9] The court also has to be remindful of the caution made by the Court of Appeal in *Kenny Heights Development Sdn Bhd v. Ketua Pengarah Hasil Dalam Negeri* [2015] 5 CLJ 923; [2015] 4 MLRA 114; [2015] 4 MLJ 487; [2015] 3 AMR 205 where it had stated as follows:

> [24] We make the general observation that courts, acting in accordance with the law, are at all times bound by the legislation placing jurisdiction and authority in specialised bodies such as SCIT. *The legislation specified that the deciding order of the SCIT is final and allowed appeals to the court on question of law and not on any grievance. It underlines, within the SCIT's jurisdiction, its authority and prevents the courts being buried under an avalanche of tax appeals by parties unhappy with the determination of the KPHDN and the SCIT*.
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> [25] Courts must also bear in mind the SCIT's specialisation. Dealing with terms and practices of the business and the business community enable them to have special insight, understanding and appreciation of the evidence and facts, to make the findings drawn from those evidence and facts. While a finding of fact often touches upon the law, the determining factor in the finding is their special insight and appreciation of the facts. *Hence, unless it is demonstrated that SCIT had erred on a question of law, resulting in a manifest error in the deciding order, the court cannot intervene, as it would amount to interference contrary to the intent of legislation setting up and empowering the SCIT*. (see *Lower Perak Co-operative Housing Society Berhad v. Ketua Pengarah Hasil Dalam Negeri* [1994] 3 CLJ 541; [1994] 2 MLJ 713; [1994] 2 AMR 1735; [1994] 1 MLRA 262). (emphasis added)

A **Issues**

[10] The following issues have been appealed by the company before the SCIT which are now required for determination before this Honourable Court being an appeal by the DGIR.

B *Company's Issues*

(i) whether s. 140A of the ITA allows the DGIR to completely disallow the interest payments without justification;

(ii) whether s. 140A of the ITA allows the DGIR to disregard the interest payment without providing a more 'suitable' arm's length rate; and

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(iii) whether the DGIR acted reasonably and within its powers provided for under s. 140A of the ITA to substitute the interest rate, which the company had proven to be arm's length, with 0%.

DGIR's Issues

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(i) whether the assessment raised by the DGIR for the YAs 2010, 2011 and 2012 all dated 29 December 2014 are in accordance with s. 140A of the ITA; and

(ii) whether the penalty imposed under sub-s. 113(2) of the ITA is correct.

E (See: rekod rayuan tambahan – Bahagian A and B at p. 4).

[11] The central issue under appeal is whether the adjustment by the DGIR made to the interest expense on the loan that is obtained by the company from its related company is in accordance with s. 140A of the ITA and the Income Tax (Transfer Pricing) Rules 2012 (TP Rules).

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The Decision Of The Court

[12] On 29 December 2014, the DGIR issued a letter along with the impugned assessments. The DGIR stated that adjustments were made pursuant to s. 140A of the ITA (decision letter). The reasons for the issuance of the additional assessments and the imposition of s. 140A of the ITA are summarised as follows:

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(i) the transaction with Watsons Labuan is a transaction with an associated enterprise;

H (ii) the company's commercial rationale behind the non-repayment of the principal sum is not in-line with art. 9 of the Model Tax Convention on Income and on Capital;

(iii) the company's transaction with Watsons Labuan is not based on terms that would have been agreed between independent parties. The DGIR contends that an arm's length transaction will provide for the payment of the principal and not just the interest alone;

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(iv) the DGIR decided to ignore the whole transaction allegedly in accordance with the powers provided under s. 140A of the ITA.

(See: pp. 739 to 745, section B, vol. 2B of the record of appeal (encl. 6)).

[13] In summary, the DGIR's basis for invoking s. 140A of the ITA is based on the allegation that:

(i) the company's transactions were not at arm's length as the company's loans did not provide for capital repayment, and as such, according to the DGIR, the interest payments in respect of the loans should be disregarded; and

(ii) the basis of the said allegation that the loans were not at arm's length is based on Investopedia and not on any analysis or any function, Asset or risk analysis on independent companies or any other transaction.

[14] It is not disputed that the DGIR is empowered to substitute the price relating to the transaction that is entered between the company and its related entities if it is not made at arm's length under s. 140A(3) of the ITA.

[15] The procedures to determine the arm's length price for the transaction between the company and its related entities are further provided under the TP Rules which are prescribed through s. 140A(1) of the ITA.

[16] Section 140A of the ITA reads as follows:

Power to substitute the price on certain transactions

140A

(1) This section shall apply notwithstanding s. 140 and subject to any rules prescribed under this Act.

(2) Subject to subsections (3) and (4), where a person in the basis period for a year of assessment enters into a transaction with an associated person or that year for the acquisition or supply of property or services, then for all purposes of this Act that person shall determine and apply the arm's length price for such acquisition or supply.

(3) Where the Director General has reason to believe that any property or services referred to sub-s. (2) is acquired and or supplied at a price which is either less than or greater than the price which it might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm's length, he may in determination of the gross income, adjusted income or adjusted loss, statutory income, total income or chargeable income of the person, substitute the price in respect of the transaction to reflect an arm's length price for the transaction.

[17] In addition to s. 140A of the ITA, r. 8 of the TP Rules states that:

(1) *The Director General may disregard any structure* adopted by a person in entering into a controlled transaction if:

(a) the economic substance of that transaction differs from its form; or

A (b) notwithstanding that the form and substance of that transaction are the same, the arrangements made in relation to the transaction, viewed in totality, differ from those which would have been adopted by independent persons behaving in a commercially rational manner and the actual structure impedes the Director General from determining an appropriate transfer price.

B (2) *Where the Director General disregards any structure adopted by a person in entering into a controlled transaction under subrule (1), the Director General shall make adjustment to the structure of that transaction as he thinks fit to reflect the structure that would have been adopted by an independent person dealing at arm's length having regards to the economic and commercial reality*. (emphasis added)

C **[18]** I find that in allowing the company's appeal, the SCIT held that:

(i) the DGIR failed to show or provide a satisfactory explanation on how the DGIR could have concluded that the company's loans were not at arm's length; and

D (ii) the DGIR failed to show or provide satisfactory explanation on how the DGIR could have concluded that 0% interest is a reasonable arm's length price.

(See: pp. 1 to 15 of the additional record of appeal (encl. 29) for a copy of the grounds of decision and pp. 15 to 16, Section A of the record of appeal E (encl. 3) for a copy of the deciding order).

[19] In coming to its decision, the SCIT relied on the relevant transfer pricing legislation namely s. 140A of the ITA and r. 8 of the TP Rules.

[20] Having read rr. 8(1) and 8(2) of the TP Rules together, it is clear that F while the DGIR has the power to disregard structures that differ from those which would have been adopted by independent persons behaving in a commercially rational manner and the actual structure impedes the DGIR from determining an appropriate transfer price, if DGIR so chooses to disregard the structure under r. 8(1), r. 8(2) requires the DGIR to make the G adjustment as it thinks fit to reflect the structure that would have been adopted by an independent person dealing at arm's length.

[21] On this issue, I find that the SCIT reached the same conclusion as reflected in the grounds of decision when it held as follows:

H [12] Under s. 140A of the ITA, the **respondent may substitute the price** in respect of the transaction to reflect an arm's length price for the transaction. Under Rule 8 of the TPR, the **respondent shall make adjustment** to the structure of that transaction to reflect that would have been adopted by an independent person dealing at arm's length.
(emphasis added)

I (See: p. 10 of the additional record of appeal (encl. 29)).

[22] In the instant case, I find that the company prepared the transfer pricing documentation in respect of the loan (TP documentation) explaining how it arrived at the arm's length interest rate of LIBOR + 3% and provided the same to the DGIR on 27 December 2013 for its review.

(See: pp. 1138 to 1151, section B, vol. 2D of the record of appeal (encl. 8)).

[23] The SCIT made a finding of fact that the company's TP documentation proved that the interest rate adopted by the company was not excessive when it held as follows:

> [16] On the other hand, the appellant prepared a transfer Pricing Report based on study which shows that the loan transactions with Watson Labuan were at arm's length. In the said report, the interest rate adopted by the appellant was compared with the commercial loan Base Lending Rates (BLR) in Malaysia and the report shows that it is lower than the BLR. Therefore, the interest rate adopted by the appellant is not excessive.

(See: p. 11 of the additional record of appeal (encl. 29)).

[24] This court is of the view that once the TP documentation which was prepared in accordance with the law is presented, the DGIR must provide its basis, supported by facts and law, for rejecting the said TP documentation.

[25] Unfortunately, having perused the relevant cause papers *ie*, appeal records and additional appeal records, I find that the DGIR failed to provide any documentation to rebut the evidence submitted by the company.

[26] The SCIT was in fact, unable to seriously consider any of the DGIR's analyses as the DGIR did not proffer any evidence that they performed any serious transfer pricing analysis report. No function, asset and risk analysis were undertaken by the DGIR that could be proved by way of documentary evidence submitted to the SCIT. Therefore, it is not surprising when the SCIT held as follows:

> [15] In this appeal, the respondent did not furnish any evidence by way of a report or an analysis of the interest rate that should have been applied by the appellant to the loan transactions with Watson Labuan. Thus, the respondent has no basis to disregard the appellant's loan transaction.

(See: p. 11 of the additional record of appeal (encl. 29)).

[27] It is evident from the company's TP documentation that:

(i) the company has provided a functional analysis covering its functions, assets and risks;

(ii) the company has provided considerations on the contractual terms and information regarding economic circumstances;

(iii) the company performed a benchmarking analysis or comparability analysis to ascertain independent companies with similar characteristics based on the findings in the functional analysis; and

(iv) finally, arriving at the conclusion that the applicable interest rate was at arm's length.

(See: pp. 1138 to 1151, section B, vol. 2D of the record of appeal (encl. 8)).

[28] I am of the view that if the DGIR disagreed with the TP documentation, the DGIR would have commissioned a counter-veiling TP study. This was not done by the DGIR.

[29] This court is of the view that the company's TP documentation was demonstrated to comply with the TP quidelines 2012 and in the absence of a contrary transfer pricing report prepared by the DGIR, the company's version must be accepted and the impugned assessments are erroneous and excessive. (*Aik Ming (M) Sdn Bhd & Ors v. Chang Ching Chuen & Ors & Another Case* [1995] 3 CLJ 639; [1995] 2 MLJ 770; [1995] 1 MLRA 546; [1995] 3 AMR 2375).

[30] The DGIR on the other hand submitted that there is no requirement for the DGIR to provide a transfer pricing report or analysis and it is not its responsibility to determine that the transaction is made at arm's length.

[31] However, I find that this position goes against long-standing legal precedent on the requirement that the DGIR must provide its own transfer pricing report should it disagree with the taxpayers. This has been explained by the following cases:

(i) *MM Sdn Bhd v. Ketua Pengarah Hasil Dalam Negeri* [2013] MSTC 10-046 the SCIT held that:

> Based on the above citation, *we the Special Commissioners are aware of the respondent's version of the shortcomings in the appellant's transfer pricing reports, but we do not know what is the respondent's version of what the transfer pricing reports ought to be in this case, not to mention that such respondent's version (if it existed) of the reports were not put to the appellant's witnesses*. Hence, the respondent is in breach of the principle enunciated in *Aik Ming*'s case (*supra*). (emphasis added)

(ii) *Ketua Pengarah Hasil Dalam Negeri v. Procter & Gamble (Malaysia) Sdn Bhd* [2022] 1 LNS 754; [2022] MLRHU 657; [2022] MLJU 743.

In this case, the DGIR appealed against the SCIT's decision where its finding was to, amongst others:

(i) that the taxpayer had proven that the transactions were carried out at arm's length based on the transfer pricing report; and

(ii) that the DGIR failed to provide its transfer pricing report or analysis to defend the adjustments made. Noorin Badaruddin J stated as follows:

[65] *The damning part of the appellant's position is the fact that they fail to provide their own transfer pricing analysis. As such the SCIT had rightly relied on the respondent's TP Documentation*. The SCIT stated as follows:

> 10.24 Panel mendapati dokumen TP yang dikemukakan oleh Perayu tersebut telah disediakan berlandas Garis Panduan Penetapan Pindahan Harga 2003, sehubungan dengan itu, oleh kerana Responden telah tidak mengemukakan dokumen TP mereka sendiri untuk diteliti oleh Panel maka Panel menerimapakai dokumen TP yang dikemukakan oleh pihak Perayu tersebut.

[66] *The SCIT could not make any serious consideration on the appellant's analysis as no documentary evidence was proffered that such analysis was done*. The SCIT made these crucial finding of facts which are unchallenged:

(a) The respondent provided a functional analysis covering the respondent's functions, risks and assets in line with paragraph 6.1 and 6.2 of the TP Guidelines 2003;

(b) The respondent provided information regarding the economic circumstances and business strategies that may affect the respondent's functions, risks and assets in line with paragraph 6.3 of the TP Guidelines 2003;

(c) The respondent was characterised as a limited risk distributor based on the functional analysis carried out by the respondent;

(d) The respondent applied the Transactional Net Margin Method (TNMM Method) wherein the return on sales, or operating margin, was applied as the appropriate profit level indicator in line with paragraph 7.62 and 10.3 of the TP Guidelines 2003; and

(e) The respondent performed a benchmarking analysis or comparability analysis to find independent companies with similar characteristics based on the findings in the functional analysis in line with paragraph 10.3 of the TP Guidelines 2003.

[67] In contrast, *the appellant fails to provide to this court their own Transfer Pricing Report. No functional, asset and risk (FAR) analysis were undertaken by the appellant that could be proved by way of documentary evidence is submitted to this court*. (emphasis added)

[32] Based on the above and having perused the SCIT's grounds of decision, I am of the view that the SCIT correctly found that there was no evidence from the DGIR to show that the company's TP documentation was unreliable and in the absence of such evidence, the company had proved its case that the interest rate was arm's length.

(See: pp. 11 to 13 of the additional record of appeal (encl. 29)).

A **Interest Rate**

[33] The DGIR submitted that:

(i) the SCIT erred in its decision on the basis of its findings that the interest rate adopted by the company is not excessive as it has been compared
B with the commercial loan base lending rates (BLR) which is lower than the BLR; and

(ii) although the company had prepared its TP documentation, the company compares the interest rate with the rate by the commercial loan BLR. However, there is no comparison made with an independent person
C using the rate in a similar transaction, thereby it has failed to show the comparability of the transaction under r. 6 of the TP Rules.

[34] However, upon perusal of the company's TP documentation shows the basis and analysis of why the comparables were chosen.

D (See: pp. 1138 to 1151, section B, vol. 2D of the record of appeal (encl. 8)).

[35] Based on the available information within the TP documentation, it is perplexing that the DGIR claims that insufficient comparison was made between transactions per r. 6 of the TP Rules.

E **[36]** In contrast, I find that the DGIR has not put forward any evidence to refute the company's TP analysis, and there is no basis on which the DGIR would have concluded that the interest charged is higher than what would have been agreed between independent persons. Therefore, I view that the DGIR's rejection of the comparables amounts to a bare denial, lacking in any evidence or basis as the SCIT had correctly held in its grounds of decision.

F **[37]** In the circumstances, the DGIR did not substantiate its allegations in any documentary form to show that the interest rate is not at arm's length. What is available is only the TP documentation prepared by the company, which was entirely disregarded by the DGIR in coming to its decisions.

G **[38]** I view that the SCIT's decision is founded on a correct application of the law and inference of facts that are consistent with the primary facts and evidence of the case as the SCIT had set out in its grounds of decision dated 19 May 2021.

((i) see: pp. 1 to 15 of the additional record of appeal (encl. 29) for a copy
H of the grounds of decision.

(ii) see: pp. 15 to 16, section A of the record of appeal (encl. 3) for a copy of the deciding order)).

Substitution Of The Arm's Length Rate

I **[39]** This court is of the view that the DGIR is utilising s. 140A of the ITA to disregard the transactions undertaken. Thus, the DGIR did not act within the powers conferred to it under the said section.

[40] It is to be noted that s. 140A of the ITA does not give the DGIR the power to disregard/ignore any transactions. Instead, s. 140A clearly requires the DGIR to substitute the price in respect of the transaction to reflect an arm's length price for the transaction where it has reasons to believe that the transactions were not carried out at arm's length.

[41] Therefore, I view that the SCIT correctly held that the DGIR's failure to make any adjustments to the loans or substitute an arm's length rate is contrary to s. 140A of the ITA:

> [14] The respondent also did not make any adjustments to the structure of the loan transactions or substitute the interest rate that would have been expected between an independent persons to the loan transaction between the appellant and Watson Labuan as stipulated in Section 140A of the ITA and Rule 8(1) and (2) of the Income Tax TPR. The respondent merely substituted the interest rate with 0% on the basis that no independent party would carry out such transaction.

(See: p. 11 of the additional record of appeal (encl. 29)).

[42] I find that the DGIR's insistence that it can substitute a price with zero is misconceived and in effect, disregarding the transaction without substituting an arm's length price. This shows that the DGIR failed to read r. 8 of the TP Rules in its entirety. The DGIR only chose to apply r. 8(1) of the TP Rules but failed to consider r. 8(2). For ease of convenience r. 8(2) is reproduced below:

> (2) *Where the Director General disregards any structure* adopted by a person in entering into a controlled transaction *under subrule (1), the Director General shall make adjustment* to the structure of that transaction as he thinks fit to reflect the structure *that would have been adopted by an independent person dealing at arm's length having regards to the economic and commercial reality*.
>
> (emphasis added)

[43] The DGIR in its submissions attempts to argue that it 'substituted' the interest with 0% because no independent person or company would enter into similar transaction. Therefore, the interest rate ought to be 0%.

[44] I find that the DGIR's arguments is devoid of merits for the following reasons:

(i) the test under r. 8(2) is not whether an independent person would enter into a similar transaction. The test is a price which "... would have been adopted by an independent person dealing at arm's length ..." The DGIR's argument is legally inconsistent with the language of r. 8(2); and

(ii) the language in r. 8(2) notwithstanding, the DGIR has not provided any evidence to support its allegations that no commercial party would enter into such transactions, I noticed that this was also the case when the matter was heard before the SCIT.

[45] In fact, I find that the loans provided to the company are similar to that of an uncommitted facility typically offered by commercial banks whereby both a borrower and a lender would have more flexibility on when to make/request a repayment of such debt. This appears in cl. 3 of the loan agreements which stipulates that the facility may be repaid at any time.

> The Lender may, at any time, by notice to the Borrower declare that all or part of any amounts outstanding under this Agreement are immediately due and payable in which event the Borrower must immediately repay the outstanding amounts so declared due together with interest accrued thereon.

(See: pp. 1154 and 1165, section B, vol. 2D of the record of appeal (encl. 8)).

[46] In addition to the above, if one were to look at the decision letter, the position taken by the DGIR is based solely on its reference to Investopedia. No other finding or TP report or any form of analysis was shown to the company nor the SCIT.

[47] This court is of the view that Investopedia is not an authority on the issue alleged by the DGIR. It is merely a website like that of Malaysiakini or even Wikipedia. The writings contained on the website are not authoritative and should not be used as a tool to determine TP analysis under s. 140A of the ITA. This shows that the justification and the reasoning on the part of the DGIR to impose s. 140A of the ITA on the company is flawed.

(See: www.investopedia.com).

[48] Furthermore, I find that the article perused by the DGIR and quoted from Investopedia is not applicable to the facts at hand. The article quoted concerns defaults and how one should engage creditors at the time of default in view of pending bankruptcy and insolvency implications. The article is not even concerned with the rates of interest chargeable in the market at the material time and whether parties are willing to accept non-payment of capital at the time the loan was undertaken. Therefore, I view that the DGIR's basis for invoking s. 140A of the ITA amounts to an error of law.

[49] Based on the above, this court is of the view that the position adopted by the DGIR is not justifiable. Failure to provide a TP report and to support this with sufficient evidence clearly shows that the DGIR did act unlawfully and wrongly. This failure, as rightly held by the learned SCIT, is fatal to the DGIR's appeal herein:

> [18] The appellant has succeeded in proving that the respondent's assessments against which an appeal is made are excessive and erroneous. The respondent failed to furnish any reason or evidence to reflect that 0% interest is an arm's length price in the transactions between the appellant and Watson Labuan. The respondent merely substituted the

> interest rate without valid reason that the said rate is either less than or greater than the rate in transaction between an independent persons might have been ...

[50] Based on the aforesaid reasons, this court is of the view that the company's TP documentation should be maintained and all adjustments made by the DGIR with regards to transfer pricing against the company should be disregarded. The SCIT in para. 16 of the grounds of decision held as follows:

> [16] On the other hand, the appellant prepared a Transfer Pricing Report based on study which shows that the loan transactions with Watson Labuan were at arm's length. In the said report, the interest rate adopted by the appellant was compared with the commercial loan Base Lending Rates (BLR) in Malaysia and the report shows that it is lower than the BLR. Therefore, the interest rate adopted by the appellant is not excessive.

(See: p. 11 of the additional record of appeal (encl. 29)).

[51] Therefore, the SCIT was correct in its interpretation of s. 140A of the ITA and r. 8 of the TP Rules that the DGIR was required to substitute the interest rate with the interest rate that it deems to be an arm's length pricing, which the DGIR failed to do so.

[52] All in all, this court is of the considered view that the SCIT's deciding order is founded on a correct proposition of the law and inference of fact and arrived based on correct conclusions drawn from the facts agreed and proved, in that:

(i) the SCIT correctly appreciated the evidence or the facts and made finding of facts which a reasonable person in the circumstances would have arrived at;

(ii) the SCIT arrived at finding of facts which are wholly supported by facts or evidence;

(iii) there are no material inconsistencies or inaccuracies in the SCIT's deciding order; and

(iv) the SCIT took into account relevant factors and disregarded irrelevant factors in arriving at its decision.

[53] I view the SCIT's findings as rational and cogent and there are no flaws in its reasoning or the conclusions therein. Based on the evidence before the SCIT, it cannot be said that the findings of the SCIT are irrational or perverse.

Penalty

[54] The DGIR submitted that the penalty under s. 113(2) of the ITA is correctly imposed after considering all the facts and circumstances of the company's case.

[55] It is not disputed that the DGIR has discretionary power to impose a penalty against the company under sub-s. 113(2) of the ITA which reads as follows:

> **Incorrect returns**
>
> (1) Any person who:
>
> (a) Makes an incorrect return by omitting or understanding any income of which he is required by this Act to make a return on behalf of himself or another person; or
>
> (b) Gives any incorrect information in relation to any matter affecting his own chargeability to tax of any other person,
>
> shall, unless he satisfies the court that the incorrect return or incorrect information was made or given in good faith, be guilty of an offence and shall, on conviction, be liable to a fine of not less than one thousand ringgit and not more than ten thousand ringgit and shall pay a special penalty of double the amount of tax which has been undercharged in consequences of the incorrect return or incorrect information or which would have been undercharged if the return or information had been accepted as correct.
>
> (2) Where a person:
>
> (a) Makes an incorrect return by omitting or understating any income of which he is required by this Act to make a return on behalf of himself or another person; or
>
> (b) Gives any incorrect information in relation to any matter affecting his own chargeability to tax or the chargeability to tax of any other person,
>
> Then, if no prosecution under subsection (1) has been instituted in respect of the incorrect return or incorrect information, *the Director General may require that person to pay a penalty equal to the amount of tax which has been undercharged in consequences of the incorrect return or incorrect information or which would have been undercharged if the return or information has been accepted as correct*; and, if that person pays that penalty (or, where the penalty is abated or remitted under subsection 124(3), so much, if any, of the penalty as has not been abated or remitted), he shall not be liable to be charged on the same facts with an offence under subsection (1). (emphasis added)

[56] Based on the above, it is clear that it is the discretion of the DGIR to impose penalties under sub-s. 113(2) of the ITA after taking into consideration all relevant facts and circumstances of the case.

[57] According to the DGIR, it was discovered during the conduct of the audit that the price in relation to the transaction between the company and its related company is not made at arm's length.

[58] Further, the DGIR submitted that the company has failed to prove that the interest rate for the transaction it has entered with its related company is comparable to the transaction between independent persons or companies.

[59] Hence, the penalty under s. 113(2) of the ITA is imposed on the amount of tax undercharged in consequence of the company submitting incorrect returns or giving wrong information affecting its own chargeability.

[60] It is not disputed that in the instant case, the company had obtained professional advice from Pricewaterhouse Coopers Taxation Services Sdn Bhd (PwC Malaysia), a reputable firm in determining its tax liability in relation to the issues at hand.

[61] To my mind, this indicates that the company did not deliberately or recklessly submit an incorrect return. The fact that the company consulted an independent professional illustrates that they had no intention to evade or avoid tax.

[62] I view that the fact that the company had acted in good faith, took professional advice and made full disclosure to the DGIR constitutes sufficient grounds to set aside the penalties imposed.

[63] I find support in my view by referring to the case of *Office Park Development Sdn Bhd v. Ketua Pengarah Hasil Dalam Negeri* [2011] 13 MLRH 493; [2011] 9 MLJ 479; [2011] MSTC 30-023 where Alizatul Khair J (as she then was) held as follows:

> [51] ... The penalty provision in ss 113(1) and 113(2) is to punish taxpayers who deliberately submit incorrect tax return and information. *It cannot be the intention of Parliament to punish taxpayers who innocently submit incorrect tax returns or those taxpayers who engage professional tax agents to prepare and submit their tax returns*.
>
> [52] Further, it is not mandatory for the respondent to impose penalty in all tax audits. I agree that the fact that the respondent has a discretion amplifies the appellant's submission that a *penalty should not be imposed in this case as the appellant had acted in good faith and made full disclosure of information*. (emphasis added)

(See: *Ketua Pengarah Hasil Dalam Negeri v. Firgos (M) Sdn Bhd* [2014] 8 CLJ 943; [2013] MLRHU 876; [2013] MSTC 30-065; [2014] 1 MLJ 701; [2014] 1 AMR 176).

[64] Further, in the then Supreme Court case of *Ketua Pengarah Hasil Dalam Negeri v. Kim Thye & Co* [1992] 4 CLJ 2079; [1992] 1 CLJ (Rep) 135; [1992] 1 MLRA 184; [1992] 1 AMR 413; [1992] 2 MLJ 708 it was held that s. 113(2) of the ITA is not a mandatory provision, but only confers discretion on the DGIR as to whether penalties should be imposed.

[65] Based on the above, it is clear that the DGIR should not act mechanically and must take into account all factors and circumstances of the case before imposing any penalty on the company.

Conclusion

[66] Premised on the aforesaid reasons, I am of the view that the decision of the SCIT is not tainted with any error or misconception of law and is supported by evidence and therefore, I find that the DGIR's appeal has no merits.

[67] As such, the DGIR's appeal is dismissed with costs of RM7,000 subject to the allocator fee.